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THE NEED FOR INTERNATIONAL COORDINATION OF MACROECONOMIC POLICY: A STUDY BY MICHAEL M. HUTCHISON OF THE UNIVERSITY OF CALIFORNIA

Summary

For the last two years macroeconomic policy coordination has been near the top of the agenda for almost every meeting of the leaders of the world's major industrial democracies. In the following article, Michael M. Hutchison, assistant professor of economics at the University of California at Santa Cruz, evaluates the benefits and costs of this course of action. His paper was originally presented at a mid-March conference in San Francisco cosponsored by the Japan Economic Institute, the Japan Society of Northern California and the World Affairs Council of Northern California. A companion article will be published in the July 8 issue of JEI Report.

Introduction

Both in policy circles and among academics, discussions of international macroeconomic policy coordination have expanded in recent years. Interest in policy coordination in turn is associated with disillusionment with the present "non-system" of flexible exchange rates, in particular the wide swings in exchange rates and burgeoning trade and financial imbalances in the world economy (see Table 1) -- especially between the world's two major industrial nations, Japan and the United States.

Serious consideration of economic policy coordination, at least on the part of the United States, coincided with the peak of the dollar exchange rate in early 1985 and was expressed in the communique issued by the finance ministers from the Group of Five major industrial nations meeting at New York's Plaza Hotel in September 1985. Since then statements of G-5 and the Group of Seven

Table 1: Alternative Measures of Current Account Balances

	1980	1985	1986	1987	1988*
United States					
Billions of dollars	$1.9	$-116.4	$-141.4	$-160.7	$-141.1
Percent of GNP	0.1%	-2.9%	-3.3%	-3.6%	-3.0%
Japan					
Billions of dollars	$-10.7	$49.2	$85.8	$86.7	$77.8
Trillions of yen	Y-2.4	Y11.6	Y14.4	Y12.5	Y9.9
Percent of GNP	-1.0%	3.7%	4.3%	3.6%	2.7%
West Germany					
Billions of dollars	$-13.8	$16.3	$38.1	$44.2	$41.4
Billions of marks	DM-25.1	DM47.4	DM82.4	DM79.3	DM69.2
Percent of GNP	-1.7%	2.6%	4.2%	3.9%	3.3%
Four Asian NIEs**					
Billions of dollars	$-9.0	$10.1	$22.9	$32.0	$25-$35
Percent of GNP	-6.8%	5.2%	10.2%	11.5%	8-10%

*Projected.
**Hong Kong, South Korea, Singapore and Taiwan.

Source: International Monetary Fund, World Economic Outlook, April 1988.

have emphasized the desire for dollar stability and a willingness to intervene in exchange markets to achieve that goal. Governments of the top industrial countries have also expressed the need to alter their macroeconomic policies in a coordinated fashion in order to achieve dollar stability and restore trade and financial balance in the world economy.

Although foreign exchange market intervention has been massive since 1985 -- first to push down the dollar in 1985 and, more recently, to support the dollar exchange rate, it is not clear how much underlying macroeconomic policies have been shifted in pursuit of the often-stated objective of restoring balance in the world economy. Nor is it clear what exactly is meant by macroeconomic "policy coordination."

This article describes policy coordination as an important component in the smooth adjustment of an integrated world economy. The study also shows that policy coordination -- at least on the monetary side -- has already gone a long way toward achieving better trade and financial balance among the major industrial countries.

Background: The Rise of Trade Imbalances

The strongest argument in support of macroeconomic policy coordination is to show its opposite effect -- the past pursuit of uncoordinated policies

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has generated the lion's share of the recent trade imbalances and wide exchange rate fluctuations. Coordinated macroeconomic policies would, to a large extent, serve to redress the imbalances associated with these previously uncoordinated policies.

It is widely acknowledged that one of the most important elements behind the recent trade and exchange rate imbalances is that the United States has pursued fiscal policies diametrically opposed to those of Japan and West Germany since the early 1980s. The United States implemented a major tax reduction in 1981 that provided significant fiscal stimulus to the economy but also resulted in a string of unprecedented, large peacetime budget deficits. Japan and West Germany, in contrast, embarked on a period of fiscal restraint aimed at reducing their already large budget deficits.

The basic macroeconomic explanation for the causal linkages between budget deficits and trade deficits is by now well-known to academics and policymakers. The cut in U.S. taxes generated a rise in the budget deficit that needed to be financed. Conceptually, either a rise in net private domestic saving (private domestic saving less private investment) or a capital inflow from abroad (foreign saving) could have met this financing requirement.

The rise in the budget deficit in the United States was not accompanied by a substantial increase in net private domestic saving. On the contrary, the U.S. private saving rate remained low both by historical and international standards. U.S. private investment was moderately strong. To a large extent, therefore, foreign funds were relied on to finance the U.S. budget deficit.

The chain of events is familiar. Higher U.S. deficits and higher demand for credit put upward pressure on interest rates and generated a foreign capital inflow into the United States. This led to both the appreciation of the foreign exchange value of the dollar and the deterioration of the U.S. trade balance. U.S. fiscal stimulus also spurred the deterioration of the trade balance by boosting overall domestic demand relative to aggregate demand abroad, thereby causing purchases of imports to rise dramatically.

The upshot of these events was that U.S. exports -- hurt by the strong dollar and relatively weak demand from foreign nations -- stagnated while imports surged. Not only did the U.S. trade position deteriorate but real domestic demand (total purchases of goods and services) ran far ahead of total production (real gross national product) from 1981 until last year. The difference between production and sales was made up by increased imports.

In contrast to the United States, the rise in Japan's budget deficit in the second half of the 1970s coincided with a sharp rise in the net private saving surplus. The first oil-price shock was followed by an expansionary Japanese fiscal policy, a sharp fall in the rate of domestic investment and a fairly steady private saving rate. As a result, the savings needed to finance Japan's growing budget deficits were simply drawn from domestic sources that had financed heretofore strong investment demand. This was the reason that the shift in Japan's general public sector (all levels of government) from surplus in the early 1970s to a series of deficits peaking at the equivalent of 5.5 percent of GNP in 1978 did not result in foreign capital inflows and the associated trade deficits.

At the end of the 1970s, however, in a major policy shift, Tokyo adopted a restrictive fiscal stance in order to reduce the budget deficit and slow the growth of a public debt that had jumped fivefold since the mid-1970s. From a fiscal balance perspective, the restrictive stance was successful: the general government budget deficit was reduced to less than 1 percent (0.6 percent) of GNP by 1986 and it has remained at that level.

Nonetheless, one consequence of the lower general government budget deficit in the face of unabated strength in net private saving is that Japan has been flush with funds to lend to the rest of the world. Capital outflows from Japan, spurred by the deregulation of international financial transactions under the 1980 Foreign Exchange Law, were partially responsible for keeping the yen weak and for Japan's increasingly large trade surpluses. Surging Japanese exports found their way to world markets generally and to U.S. markets in particular, attracted by the strong dollar and the high growth of aggregate demand (associated with the fiscal expansion) after 1982.

A similar, though less dramatic, experience occurred in West Germany. Its general government budget deficit peaked at 3.7 percent of GNP in 1981. The systematic exercise of fiscal restraint gradually narrowed the budget deficit to 1.2 percent of GNP by 1986.

What is Macroeconomic Policy Coordination?

In the hope of redressing the imbalances that have plagued the world economy since the early 1980s, a number of policymakers and academics have suggested formal coordination of macroeconomic policies among the major industrial countries. Interpretations of the term "macroeconomic policy coordination" have ranged from simple consultation to clearly defined, mutual commitments by governments to alter their own policies in order to achieve a common objective or to help each government achieve its own objectives.

Consultation may be thought of as a weak form of policy coordination, involving the exchange of information among countries with a unilateral or collective commitment to act on the basis of the information. These information exchanges take place both formally and informally via bilateral meetings, international forums (e.g., G-5 and G-7 meetings) and in the context of international institutions (e.g., the International Monetary Fund and the Bank for International Settlements). Of course, these consultations are typically not simple information exchanges but involve interpretation of events and an attempt by governments to convince each other to alter their analyses and sometimes their preferences.

A more appropriate interpretation of macroeconomic policy coordination -- and the one that will be employed here -- denotes clearly defined, mutual commitments by governments to alter their own policies in order to achieve a common objective or to help each government achieve its own objectives. Such coordination involves a "package" of policy changes that would not take place in its absence. More precisely, one interpretation of macroeconomic policy coordination refers to an agreement by two or more countries to implement a set of policy changes that neither would wish to undertake on its own; each country expects the package to make it better off relative to the case where each sets its policies independently, taking the other's actions as a given.

Under this definition the gains from cooperation derive from the "spillover" effects of the other nation's actions, which presumably would not have occurred had the focus nation acted independently. These spillover effects may work either directly or indirectly. An example of direct spillover effects would be a coordinated expansion of aggregate demand abroad that expands international trade and generates export-led growth. An example of indirect effects would be when the home country is given the leeway to lower domestic interest rates and follow an expansionary monetary policy without depreciating its foreign exchange rate because other nations are following a similar policy in a coordinated fashion.

Back to Bretton Woods and Fixed Exchange Rates?

The Bretton Woods system of fixed exchange rates prevailing in the 1950s and 1960s often has been used as an example of macroeconomic policy coordination in the extreme: policies presumably had to be coordinated and synchronized to avoid balance of payments crises and revaluation of exchange-rate parities. Under the preferred interpretation of policy coordination, however, the Bretton Woods system would not have qualified. The reason is that under Bretton Woods the United States was clearly in the dominant position and largely set domestic macroeconomic policies independently of its major trading partners.

Europe, Japan and Canada under the Bretton Woods system were sharply constrained in their ability to follow independent policies because of their commitment to maintain fixed exchange-rate parities. Following a divergent, independent macroeconomic policy very likely would have generated significant international payments imbalances that, in turn, would have placed pressures on exchange rates. In this sense, the Bretton Woods system was not so much an example of successful policy coordination as it was an example of a fixed exchange-rate system where the dominant reserve-currency country set macroeconomic policies with little or no consultation with other nations, letting them adjust their own domestic policies to preserve the system of fixed rates.

The dominant position of the United States was also enhanced because the U.S. dollar was the primary reserve currency. Thus, the central banks of Europe, Japan and Canada were commited to buy or sell dollars on demand to finance international transactions imbalances as they arose. The United States, as a rule, did not play a major role in the day-to-day operations to maintain fixed exchange-rate parities, allowing the burden to fall on the non-reserve currency countries in the system.

The important point is that the countries involved did not agree to clearly defined, mutual commitments to achieve a common objective. The United States was the dominant party; it set policy largely independently to achieve its own objectives and, as the primary reserve currency nation, was not forced to buy and sell dollars on demand to maintain fixed exchange-rate parities.

The burden of policy coordination or, more appropriately, synchronization, was therefore placed primarily on Europe, Japan and Canada. Often these nations were constrained to follow policies perceived to be incompatible with their own best interests. In fact, the major reason the Bretton Woods system of fixed parities fell apart in 1971 and the Smithsonian agreement that replaced it collapsed in 1973 was that foreign nations became increasingly reluctant to follow the expansionary fiscal and monetary policy course being set by the United States and to suffer the inflationary consequences that followed.

Without macroeconomic policy synchronization, relatively large payments imbalances developed that had to be financed by central bank purchases of dollars in the foreign exchange market. The precariousness of this situation was soon seen by private-market participants, who expected a major devaluation of the dollar and, as a consequence, massive capital flows away from dollar assets to foreign currency assets. In the face of the huge international financial imbalances generated by "speculative" capital flows away from dollar assets (which were in addition to the underlying fundamental imbalances generated by uncoordinated macroeconomic policies), purchases of dollars through central bank intervention in the foreign exchange market were massive and soon became untenable. The system of fixed parities quickly collapsed as foreign central banks made the conscious decision to limit further dollar purchases rather than completely lose domestic monetary control.

How Would Macroeconomic Policy Coordination Work in Practice?

As opposed to the Bretton Woods system, true macroeconomic policy coordination would involve the major industrial countries setting mutually agreed on policies with the intent of achieving certain well-specified objectives. These objectives would presumably be negotiated and benefit all the parties to the agreement, although the distribution of the net gains from following coordinated policies would necessarily also have to be negotiated and may well vary over time depending on the economic circumstances.

The two major levers of macroeconomic policy are monetary and fiscal policies, where the latter encompasses aggregate government expenditures and tax policies as well as their composition. A secondary lever of policy is central bank intervention in foreign exchange markets. The primary levers -- monetary and fiscal policies -- would need to be set in a coordinated fashion, the particulars depending on the ultimate policy objectives. The primary policy levers would work to attain medium- and long-term objectives, while central bank intervention in foreign exchange markets (purchases and sales of foreign currency by central banks) would work to finance short-term imbalances and help maintain exchange rate stability.

Explicit Policy Rules Versus Broad-Based Discretionary Policy Actions

Once the objectives of policy have been agreed on, it becomes a technical matter as to what configuration of monetary and fiscal policies in the coordinating countries is likely to achieve these objectives. Technical economists, armed with simulations of large-scale internationally linked macroeconomic models, would present policymakers with the various alternatives. The policymakers then would negotiate simultaneously for a particular objective (in terms of exchange rates, trade balances, economic growth and inflation) and a set of policies designed to achieve that objective.

Although in principle this could be an enormous exercise -- evaluating multiple objectives and multiple policy configurations in a multicountry setting -- in practice it amounts to something such simpler. Policymakers are rightfully suspicious of the ability to fine-tune the economy with great precision and question the accuracy of very specific forecasts of the world economy. As a consequence, two basic approaches to policy coordination usually dominate discussions. The first is to set explicit policy rules by which monetary or

fiscal authorities are constrained. For example, containing exchange rate fluctuations within a narrow band is the constraint facing policymakers within the European Monetary System.

Prof. Ronald McKinnon has argued forcefully for one such proposal involving coordination by the United States, Japan and West Germany. He suggests a policy rule under which these nations would establish an average noninflationary money growth rate for themselves as a group and also share a mutual commitment to intervene in exchange markets to maintain fixed exchange rates. Each country's money growth rate would vary around the group average depending on whether its currency was under upward or downward pressure.

Countries whose currencies were under downward pressure would sell foreign exchange and buy their currencies in the foreign exchange market. This would contract their domestic money supplies, which then would grow at a rate below that set for the group as a whole. Countries whose currencies were under upward pressure would buy foreign currencies, sell their domestic currencies and expand their money supplies at a rate above the group average. Prof. McKinnon's proposal is "rule-based" and involves a commitment to maintain fixed exchange rates both through central bank intervention and the coordination of monetary policy in a symmetrical manner.

As opposed to explicit policy rules, the second basic approach to policy coordination is to agree on a broadly defined set of policies. Policy coordination, for example, may simply refer to one nation following a more expansionary aggregate demand policy by lowering interest rates through monetary stimulus, while another country agrees to a more contractionary aggregate demand policy implemented by lowering the domestic budget deficit. Either through specific rules or general policy actions, policies can be coordinated across nations in a very broad sense.

Coordination Since the Louvre Agreement

The February 1987 Group of Seven meeting at the Louvre is an example of broad-based policy coordination designed to help redress trade imbalances and exchange rate misalignments. The communique following the Louvre meeting stated that currencies were now "within ranges broadly consistent with underlying fundamentals." The governments agreed to stabilize the dollar both by altering their macroeconomic policies and by intervening in the foreign exchange markets to prevent "excessive" volatility. Since the Louvre G-7 meeting, central bank intervention in the foreign exchange markets has been massive. West German reserves jumped more than 50 percent last year, growing to $78.8 billion from $51.7 billion. Japan's reserves jumped more than 90 percent in 1987, climbing to $81 billion from $42.3 billion. Italy, the United Kingdom, France and Canada had similar gains from their attempts to hinder the fall of the dollar.

From the medium- and long-term view of macroeconomic policy coordination, however, the important point is that the central banks of West Germany and Japan have allowed a large part of their dollar purchases in the foreign exchange markets to have monetary effects (i.e., they have been "unsterilized") since the Louvre agreement. As a consequence, the monetary stances of both West Germany and Japan shifted and money growth in these nations has been rapid over the past year. In Japan the growth rate of the broadly defined money supply

(M2+CDs) has accelerated almost continuously since the beginning of 1987; for the October-December quarter it hit 11.8 percent -- the highest rate since the second quarter of 1979. Similarly, money growth in West Germany overshot target ranges for the second year in a row.

Supporting these moves, both the Bank of Japan and the Bundesbank lowered their central bank discount rates by 50 basis points in early 1987. Money market interest rates also declined in both countries; rates in Japan decreased from 4.18 percent in December 1986 to 3.2 percent recently, while rates in West Germany dropped from 5 percent to 3.2 percent over the same period.

These actions already have proved very successful, although this fact often is not sufficiently appreciated. As a direct consequence of monetary ease, real domestic demand last year grew by 5.1 percent in Japan and 2.8 percent in West Germany -- despite the rapid appreciation of their currencies against the dollar and the consequent negative contribution associated with net export deterioration. Real aggregate demand in the United States, in contrast, grew 2.5 percent -- down sharply from the 3.9 percent growth rate of 1986 (see Table 2).

Table 2: Indicators of Economic Performance for the United States, Japan and West Germany

(annual growth rates, in percent)

	Actual			Projected	
	Average 1975-85	1986	1987	1988	1989
Real GNP					
United States	2.6%	2.9%	2.9%	2.9%	2.7%
Japan	4.3	2.4	4.2	4.1	3.8
West Germany	2.0	2.5	1.7	1.7	1.7
G-7 Country Average	2.7	2.8	3.1	2.9	2.7
Real Domestic Demand					
United States	2.9	3.9	2.5	1.7	2.2
Japan	3.3	4.0	5.1	5.6	4.4
West Germany	1.8	3.7	2.8	2.7	2.0
G-7 Country Average	2.6	3.8	3.4	2.9	2.7
GNP Deflator					
United States	6.8	2.6	3.0	3.2	3.5
Japan	3.7	1.9	-0.1	1.2	1.5
West Germany	3.8	3.1	2.1	2.0	2.0
G-7 Country Average	7.2	3.0	2.7	2.9	3.0

Source: International Monetary Fund, World Economic Outlook, April 1988.

The maintenance of aggregate demand stimulus in Japan and, to a lesser extent, in West Germany, combined with the depreciation of the dollar exchange

rate, has had the desired effects on international adjustment: demand growth outstripped output growth in both Japan and West Germany (real GNP growth in 1987 was 4.2 percent and 1.7 percent, respectively, as shown in Table 2); the difference was made up by increased imports. As a consequence, the current account surplus dropped between 1986 and 1987 from 4.3 percent to 3.6 percent of GNP in Japan and from 4.2 percent to 3.9 percent of GNP in West Germany. The most recent International Monetary Fund forecast suggests that, with unchanged policy stances, Japan's current account surplus likely will drop to 2.7 percent of GNP this year and 2.5 percent in 1989 while Germany's current account surplus likely will fall to 3.3 percent this year and 3.1 percent in 1989 (see Table 3).

Table 3: Current Account and Saving-Investment Balance

(percent of GNP)

	Actual			Projected	
	Average 1975-85	1986	1987	1988	1989
United States					
Current Account Balance	-0.7%	-3.3%	-3.6%	-3.0%	-2.6%
General Government Fiscal Balance	-2.0	-3.5	-2.4	-2.2	-1.9
Gross Private Investment	16.3	16.3	16.0	16.1	16.1
Japan					
Current Account Balance	1.0	4.3	3.6	2.7	2.5
General Government Fiscal Balance	-3.5	-0.6	-0.8	-0.8	-0.7
Gross Private Investment	24.7	27.5	28.9	29.6	29.8
West Germany					
Current Account Balance	0.5	4.2	3.9	3.3	3.1
General Government Fiscal Balance	-2.9	-1.2	-1.7	-2.7	-2.3
Gross Private Investment	16.4	17.7	17.7	17.5	17.6
Seven Major Industrial Countries					
Current Account Balance	-0.2	-0.2	-0.4	-0.4	-0.3
General Government Fiscal Balance	-3.1	-3.2	-2.6	-2.4	-2.3
Gross Private Investment	18.1	18.4	19.9	19.5	19.9

Source: International Monetary Fund, World Economic Outlook, April 1988.

The burden of monetary adjustment so far has fallen on West Germany and Japan. The relatively expansionary U.S. monetary policy remained largely unchanged in 1987; a mid-year attempt to push interest rates up was abandoned after the October stock market collapse.

Fiscal policies also generally have moved in the right direction to help restore international balance. U.S. fiscal policy was sharply contractionary

last year. Between 1986 and 1987 the general government fiscal balance (all levels of government -- local, state and federal) improved from a deficit of 3.5 percent of GNP to -2.4 percent of GNP. IMF anticipates further reductions, projecting a 2.2 percent general government fiscal shortfall this year and only 1.9 percent in 1989.

The adjustment process also has been helped by moderately expansionary fiscal policies abroad. West Germany's budget deficit increased from 1.2 percent of GNP in 1986 to 1.7 percent in 1987 and is projected to rise sharply to 2.7 percent this year. Japan, in contrast, has maintained a roughly unchanged fiscal stance over the past two years. Japanese fiscal policy continues to be politically constrained by the long-term government objective of slowing the growth of the public debt. The introduction of a new indirect tax, such as the 3 percent general consumption tax now being discussed by the government and the Liberal Democratic Party, would further reduce the budget imbalance unless it is accompanied by cuts in other taxes. However, an increase in indirect taxation also would work against international coordination of fiscal policy.

On balance, however, monetary policies -- and, to a lesser extent, fiscal policies -- have moved in the right direction to help redress international payments imbalances since the Louvre agreement. The cooperative nature of the Louvre G-7 meeting was an important factor helping to coordinate macroeconomic policies among the major industrial nations.

Although overall financial imbalances are gradually being corrected, particularly in Japan and West Germany, one sore point remains: the current account deficit of the United States, unlike the surpluses of Japan and West Germany, is seemingly stuck at a high level. Both in nominal terms and as a percent of GNP, the U.S. current account balance deteriorated further in 1987. This development surprised and alarmed policymakers and analysts alike. Nonetheless, all signs point to significant current account and trade balance adjustments this year. The U.S. current account deficit should narrow from 3.6 percent of GNP in 1987 to 3 percent this year and 2.6 percent in 1989.

Who Should Coordinate Policies?

Once one accepts the argument in principle that some form of macroeconomic policy coordination is preferable to the present "non-system," a number of practical issues arise involving implementation. One question concerns which countries should participate.

There are tradeoffs between having too few countries formally participate and too many. One potential drawback of too few participants is that a major part of the world economy would be excluded from the coordinaiton effort. This would limit the ability of the coordinating nations both to protect themselves from unforeseen external economic disturbances and to achieve common objectives that depend in part on a noncooperating trading partner. One potential benefit of having only a small group of countries involved, on the other hand, is that compromises on the objectives of coordinated policies presumably could be reached in a reasonable time frame. There also would be an increased probability that agreement could be reached on an appropriate set of policies to achieve these objectives.

In practice, coordinating the macroeconomic policies of the United States, Japan and West Germany -- similar to what has occurred since the Louvre

agreement -- very likely would prove sufficient to achieve a large degree of economic stability in the world economy. Coordination among the so-called "Group of Three" also very likely would prove sufficient to achieve their common macroeconomic objectives. There are several reasons for this. First, these nations together contribute a large share of the total real output of the members of the Organization for Economic Cooperation and Development. Second, as long as West Germany remains the dominant figure in the European Monetary System, the other EMS nations automatically would coordinate (or, as the term was used above, synchronize) their policies with those of West Germany, which in turn is working with the United States and Japan. The United States, Japan and the EMS nations make up more than four-fifths of the total GNP of the OECD countries and clearly would prove the dominant force in any economic fluctuations facing the industrial world.

Coordination With Different Policy Objectives

Perhaps the largest obstacle to policy coordination in the past has been real or perceived differences in the "policy objective functions" of different nations. Usually this is described in terms of the different sensitivities of governments to potential unemployment-inflation tradeoffs. It may also encompass iifferent views on acceptable ranges of exchange rates and trade balances.

For example, the European Monetary System is a system of fixed exchange-rate parities around a narrow band that repeatedly comes under pressure for adjustment because macroeconomic policies frequently are uncoordinated. A continual point of contention in the EMS when imbalances arise is the appropriate combination of devaluation by the deficit countries and revaluation by the surplus countries. A second point of contention is whether the burden should be placed solely on exchange rate adjustments or on a mix of exchange rate adjustments and macroeconomic policy adjustments -- either expansionary aggregate demand policies in the surplus countries or contractionary aggregate demand policies in the deficit countries.

Traditionally, the burden of adjustment has fallen primarily on the "weak" currency country experiencing deficits. It usually has taken the form of currency depreciation and a contraction in aggregate demand, which generally is implemented by both tightening monetary policy (typically by directly raising interbank interest rates) and raising taxes and cutting government expenditures. Within the EMS, however, the deficit nations have been increasingly reluctant to bear the entire adjustment burden; as a consequence, intense negotiations have followed and compromises acted on.

It is not likely to be a simple task for nations to agree on a common set of objectives as a first step toward coordinating policies. This is primarily a political problem, not an economic one. It is often politically unpopular to implement policies that in the short term have adverse employment and output consequences or are viewed by the public as implemented primarily because of domestic acquiescence to foreign pressure. But it must be kept in mind that there have been reasonably successful attempts at a very high degree of economic policy coordination (e.g., the EMS). The primary reason so much attention has been focused on policy coordination over the last two years or so is due to the perception that the present "non-system" has costs, both politically and economically, that presumably outweigh those of a system of coordinated policies.

The Benefits Outweigh the Costs

It is not likely to be an easy task to systematically coordinate macroeconomic policies internationally. This is not surprising considering the internal political difficulties every nation typically faces in attempting to design an internally consistent set of monetary and fiscal policies. But economic events since the beginning of the 1980s -- large and growing trade imbalances, wide swings in real and nominal exchange rates and recurring trade and industrial dislocations -- suggest that an alternative to the present "non-system" is desirable. Moreover, the experience of the past two years indicates that broadly defined, loose coordination of macroeconomic policies is not only good politics -- by helping to avert protectionist pressures associated with unrelenting trade imbalances -- but also good economics. The loose coordination of policies agreed to at the February 1987 Louvre G-7 meeting already has helped to restore trade, financial and exchange-rate equilibrium in the world economy. Moving back to uncoordinated and often divergent policies will only make matters worse.

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